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Looking for Certainty

Potential investors often say that "uncertainty" keeps them out of the financial markets. "I'll stay in cash until the direction becomes clearer," they will say. But, when has there ever been total clarity?

Alternatively, people who are already in the market after a strong rally, as we have seen in recent years, nervously hear media commentary about possible pullbacks and ask, "Is now a good time to move to the sidelines?"

While these emotion-driven swings based on forecasts and predictions are understandable, they are also unnecessary. Instead, strategic rebalancing provides a better solution, which we will explain in a moment.

But first, think back to March 2009. With equity markets deep into a bearish phase, the Associated Press provided its readers with five signs the stock market had bottomed out and followed that up with five signs that it hadn't.[1]

The case for an upturn was convincing. Volumes were up, the slide in the US economy appeared to be slowing, banks were returning to profitability, commodity prices had bounced, and many retail investors had capitulated and gone to cash.

But there also was a case for more pain to come. Toxic assets still weighed on banks' balance sheets, economic signals were patchy, short-covering was driving rallies, the Madoff scandal had knocked confidence, and fear was still widespread.

Of course, with the benefit of hindsight, that month did mark the bottom of the bear market. In the following five years, major equity indices have rebounded to all-time or multi-year highs.

Exhibit 1 (on next page) shows the cumulative performance of the S&P 500 Index in the 16 months or so of the bear market beginning November 2007, and then the cumulative performance in the subsequent recovery period.

You can see there have been substantial gains across the board since the market bottom. And while annualized performance over the six-and-a-half years from November 2007 is below long-term averages, there has been a significant recovery for those who did not bail out in March 2009.

Exhibit 1 S&P 500 Index Performance: Financial Crisis and Post-Crisis
Returns (USD%)

The Decline	The Recovery	Entire Period	
11/01/2007–2/28/2009	3/01/2009–6/30/2014	1/01/2007–6/30/2014	1/01/2007–6/30/2014
Cumulative	Cumulative	Cumulative	Annualized
-50.5%	198.7 9%	45.56%	5.90%

Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Those who got out of the market at the peak of the crisis and waited for "certainty" may have realized substantial losses.

But keep in mind that these past five years of recovery in equity markets have also been marked by periods of major uncertainty.

In 2011, Europe was gripped by a sovereign debt crisis. Across the Atlantic, Washington has been hit by periodic brinksmanship over the US debt ceiling. In Asia, China has grappled with the transition from export-led to domestic-driven growth.

Around any of these events, there were a broad range of views about likely outcomes and the impact on the financial markets. The big question for the rest of us is what to do with all this commentary.

The fact is, even professionals struggle to consistently add value using analysis of macroeconomic events, as we see repeatedly in surveys of fund-versus-index returns. And history suggests that those looking for "certainty" around such events before investing could be setting themselves up for a long wait.

Recently, the focus has been on low volatility, particularly when compared to 2008–09. Today's articles muse over whether risk is being appropriately priced and whether volatility is being unnaturally suppressed by central banks' explicit forward guidance about policy.[2]

Just as in March 2009, one does not have to look far to find well-reasoned discussion in support of why the market has topped out, alongside equally compelling reasons why the rally might continue for some time.

What is the average investor supposed to make of all this conjecture? To debate the market implications of news and to try to anticipate what might happen next is difficult, as there are always cogent-sounding arguments on both sides.

An alternative approach is much simpler. It begins by accepting the market price as a fair reflection of the collective opinions of millions of market participants. So rather than betting against the market, you work with the market.

This means building a diversified portfolio according to your own needs and risk appetite, staying disciplined

within that allocation, and regularly rebalancing your portfolio. Under this approach, shares are typically sold after a solid run-up in the market. The trigger for rebalancing is not media speculation, but rather the need to maintain your desired level of risk.

Say you have chosen an allocation where 60% of your portfolio is in equities and 40% is in fixed income. A year goes by and stocks have rallied strongly so that the balance between the two has shifted to 70%/30%. In this case, it makes absolute sense to take some money out of stocks and move it to bonds or cash.

It works the other way too, so that if stocks have fallen in relation to bonds, you can take some money out of fixed income or cash and buy equities. Essentially, this equates to buying low and selling high.

Of course, this doesn't mean you can't take an interest in global events. But it does spare you from basing your long-term investment strategy on the illusion that somewhere, at some time, "certainty" will return.

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Sources

1. "Five Signs the Stock Market Has Bottomed Out and Five Signs It Hasn't," *Associated Press*, March 15, 2009.
2. "When Moderation is No Virtue," *Economist*, May 22, 2009.

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